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New World

A new home-financing industry is rising out of the inflationary wreckage of the late 1970's and early 1980's. Thrift institutions and other mortgage lenders are still uncertain about the overall dimensions of the new industry, but they're quite certain about one point—the long-term fixed-rate mortgage is dead. Potential home buyers, while unhappy about that prospect, can console themselves with the thought that mortgage-credit flows henceforth are likely to be more stable (although perhaps higher-priced) than in the past.

The world of home finance began to shift in the 1970's with revolutionary changes on the liability side of bank and thrift-institution balance sheets, as they began to pay market-determined interest rates for at least some of their liabilities. Now, in the 1980's, revolutionary changes are beginning to appear on the other side of their balance sheets, as they attempt to offset higher costs of funds. This trend in assets has failed to catch up with the trend in liabilities, however, and the mismatch has created a difficult transition period, making the first half of 1981 perhaps the worst period for earnings in the thrift industry's history.

Most institutions will survive and even prosper (eventually) in the new environment, but to do so, they will have to understand the forces that created the present situation, including the interaction of inflation with tax structures and regulatory constraints. They will also have to understand the demographic factors supporting the basic demand for home finance, as well as the many non-housing demands (such as re-industrialization) which compete for funds with housing in the nation's credit markets.

Phenomenal success

Amidst all this turmoil, many critics forget the industry's phenomenal success in keeping a roof over the nation's people during recent decades. According to the latest Census figures, the housing stock increased 28 percent (to 88.3 million units) during the past decade, in contrast to an 11½-percent increase in the total population (to 226.5 million). With this and the earlier housing upsurge, the number of persons per household dropped sharply, from 3.3 in 1964 to 2.7 persons in 1980. The quality of the housing stock also improved considerably over time, measured by increases in floor area per occupant or by improvements in such amenities as garage space or central air conditioning. In this connection, new homes are twice as large today as they were early in the post-World War II era; indeed, the typical mobile home today is as large as the typical single-family home of that earlier era.

Home-financing statistics have shown similar growth; for example, mortgage-credit flows were three times higher in 1979 than they were a decade before. But the home-financing industry suffered great swings in flows of funds during this period (see chart), and imparted immense volatility to the heavily credit-dependent housing industry. Housing starts thus declined by half or more in the 1973-75 slump and again in the 1978-80 downturn. And in the last several years, many first-time home buyers found it impossible to find affordable housing despite the vast growth of "creative financing" deals.

Demographic, investment factors

Demographic factors will strongly affect the demand for home financing in this decade, just as in the 1970's, especially since the maturing of a younger generation always leads to a heavy demand for housing services. The boom of the 1970's was sparked by a jump of 6.9 million (23.5 percent) in the population aged 25-34. Some experts believe that the shift of that group into the 35-44 category will stimulate further demand in the 1980's, although much of that stimulus probably occurred in the 1970's, as young individuals fled into housing as an inflation hedge. In the first half of the 1970's alone, the home-ownership rate jumped from 39 to 46 percent among individuals below the age of 30. New demand in the present decade thus may have to rely upon the somewhat smaller (4.9 million) increase in the number entering the 25-34 age category.

Meanwhile, housing will have to compete for funds throughout this decade with the increased financing requirements of other sectors of the economy. These requirements stem from the national consensus to re-arm, to re-energize, and to re-industrialize—all of which will require massive amounts of funds during this decade. These pressures suggest that households will have to pay considerably more for funds in coming years, apart from the higher costs associated with the move to a deregulated mortgage market.

Problem of thrifts

Those factors aside, housing's immediate crisis centers around the problems of the home-financing industry, which has found that borrowing short and lending long is a losing proposition when inflation upturns the typical structure of interest rates. Last year was the worst since 1975, and this year could be even worse. In 1980, net mortgage lending and deposit flows at thrift institutions each dropped about 30 percent for the year, and more than one-fifth of all thrifts posted red ink for the year. In the first half of 1981, some analysts expect the 5,000 savings-and-loans and mutual savings banks to lose altogether more than $1.5 billion—an industry record.

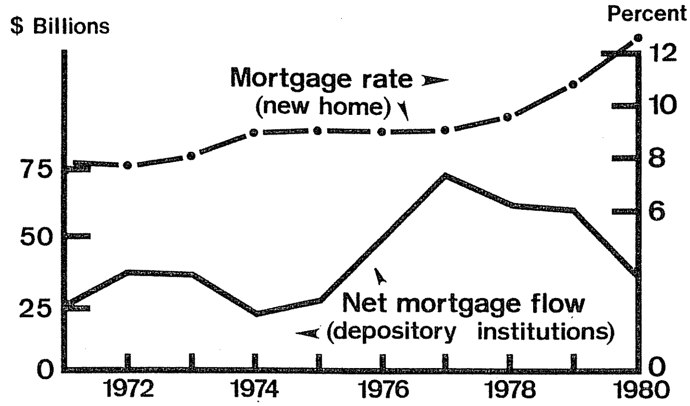
This bleak earnings picture reflects a mismatch between the thrifts' sluggish asset yields and their market-responsive and increasingly deregulated liability structures. Almost two-thirds of S&L's total mortgage portfolios yield less than 10 percent, while more than half of their deposits consist of variable-rate certificates tied to high open-market rates. According to an official of the U.S. Savings and Loan League, "You can't go on forever paying 15 percent on savings with 9 or 10-percent mortgages." Paralleling the upsurge in inflation, average new-home mortgage rates jumped from 9 percent in 1976 to 12½ percent in 1980 (see chart)—and hover around 15 percent today—but that has failed to help the thrifts with their heavy burden of older mortgages.

Problem of buyers

Meanwhile, buyers have found that the standard mortgage instrument, developed originally in a time of stable prices, has proven unworkable in a time of inflation. The borrower must pay the same amount each month for many years, even though the dollars he pays in the early part of the period will be worth much more than the dollars he pays in later years. This creates a major stumbling block for a first-time home buyer, who must commit a high proportion of his current income to housing in the hope that the payments will become less burdensome at a later date.

Would-be buyers will try to make that first step, however, because they see the inflation-bloated equity gains that have accrued to earlier home buyers over the years. That amount, estimated to be larger than one-trillion dollars, serves many home owners as a source of ready cash. According to housing expert Anthony Downs, home buyers recently have taken out about one-third of the equity from sales of their old homes in the form of cash, using it for such purposes as education, vacations, and consumer-durable purchases.

Would-be buyers can also see the advantages to home purchasers of a tax code that was not designed for inflationary times. The U.S. income-tax system allows a deduction against income for all interest paid, which means that in an inflationary environment, the IRS permits the home purchaser to deduct sums that really amount to amortization of his mortgage indebtedness. Moreover, as inflation pushes more and more people into higher tax brackets, it steadily raises the value of these home-owner deductions, and thus makes housing more and more attractive as



an investment. According to Federal budget estimates, the deductibility of mortgage-interest payments will provide a "tax expenditure" (subsidy) of $25 billion in fiscal 1982, while the deductibility of property-tax payments will amount to $11 billion more.

Deregulation cure

The problems of first-time home buyers and their lending institutions will lessen if and when inflation is wrung out of the economy. A shift in tax structures could also help, although little may happen in this respect in the near future—except perhaps some relief for depositors who now suffer the fate of having part of their capital taxed as it is returned in interest. But in another respect, the process of reform has already begun with the gradual disappearance of regulatory constraints under the terms of the historic Depository Institutions Deregulation and Monetary Control Act of 1980. In particular, the legislation called for the dismantling of all deposit-rate ceilings by late 1986.

The process of deregulation began even before the passage of the Act, when regulatory authorities permitted depository institutions to offer money-market certificates tied to open-market rates—certainly the leading financial innovation of the past decade. The certificates were designed to enable institutions to remain competitive for deposit funds during periods of rising interest rates, which in the past would have led to a complete disappearance of such funds. Mortgage lenders also improved their ability to finance housing by developing mortgage-backed bonds, which are debt instruments collateralized by pools of mortgages.

Developing a solution

Altogether, mortgage lenders face a severe dilemma today. If they pay the going rate for funds, they'll operate with losses because of the low fixed yields on their long-term mortgage commitments; but if they don't pay the going rate, their funds will move into money-market funds or other unrestricted investment outlets. Yet that situation will resolve itself with time, when the old fixed-rate mortgages are paid off, and when lending institutions build up their stock of variable-rate and other assets that move up and down in yield to match the yields that investors demand.

Regulatory authorities have already adopted certain variations on that formula. For example, the Comptroller of the Currency recently permitted Federally-chartered banks to write mortgages with rates that could change as much as one percentage point in any six-month period. Regulators also are considering other steps to help mortgage lenders in the present crisis, such as expanding the secondary market for low-interest mortgages, or perhaps allowing S&L's to write off their losses on secondary-market loan sales over a ten-year period. In addition, some analysts have called on Congress to permit the rescue of failing institutions by institutions in other states or other segments of the financial industry.

Meanwhile, the search continues for mortgage innovations which would allow the all-important first-time buyer to leap the hurdle into home-ownership. These innovations—such as the graduated-payment mortgage and the shared-appreciation (piece of the action) mortgage—would mean that borrowers and lenders both would share in the risks and the benefits of inflation. But this would also enable borrowers to obtain more housing services over time. Overall, in this new world of housing finance, mortgage funds will remain available, with no more credit crunches, but at higher and more variable rates than in the past. Indeed, the monthly mortgage payments of the future might look suspiciously like the long-forgotten rental payments of an earlier generation—except for their special feature of being deductible from income taxes.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/1/81	Change from 3/25/81	Change from year ago Dollar	 Percent
Loans (gross, adjusted) and investments*	146,672	– 65	7,493	5.4
Loans (gross, adjusted) — total#	124,355	156	6,938	5.9
Commercial and industrial	36,608	320	1,833	5.3
Real estate	51,508	113	5,854	12.8
Loans to individuals	22,752	– 620	– 1,677	– 6.9
Securities loans	1,563	175	625	66.6
U.S. Treasury securities*	6,581	– 222	74	1.1
Other securities*	15,736	1	481	3.2
Demand deposits — total#	43,418	4,140	– 3,412	– 7.3
Demand deposits — adjusted	30,348	1,928	– 1,926	– 6.0
Savings deposits — total	31,016	792	3,792	13.9
Time deposits — total#	75,899	– 334	13,872	22.4
Individuals, part. & corp.	67,099	– 168	13,516	25.2
(Large negotiable CD's)	29,078	– 264	7,176	32.8

Weekly Averages of Daily Figures	Week ended 4/1/81	Week ended 3/25/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	116
Borrowings	118	139	42
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 74

* Excludes trading account securities.
# Includes items not shown separately.

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